


MFP COMMITTEE #1  
June 26, 2006

## MEMORANDUM

June 22, 2006

TO: Management and Fiscal Policy Committee

FROM: Stephen B. Farber, Council Staff Director 

SUBJECT: Update – GASB Statement on Other Post-Employment Benefits (OPEB)

This update deals with the impact on County agencies of Governmental Accounting Standards Board (GASB) Statement 45, Financial Reporting for Other Post-employment Benefits (OPEB). The benefits involved are chiefly retiree health benefits, as distinct from pensions.

Starting in FY08, the County and other jurisdictions with annual revenue greater than \$100 million will have to disclose in their financial statements their liability for these benefits. Most governments now fund these benefits on a current year basis and do not set aside the large assets required to offset future costs. GASB Statement 45 does not require such pre-funding but does establish the basis for initiating it. Moreover, as Mr. Firestone has noted, credit rating agencies expect that AAA jurisdictions like the County will do so decisively.

### **Previous Work by the Committee and County Agencies**

Starting in February 2003, when GASB issued exposure drafts, the Committee and the agencies were among the first state and local officials to address this issue. At the Committee's request, the agencies' finance, budget, benefits, and legal staff met three times in 2003 to develop a common understanding of relevant questions. They also took an important step by obtaining updated valuations of their retiree group insurance obligations as of July 1, 2003.

At its most recent GASB worksession on November 28, 2005, the Committee reviewed the agencies' further progress and agreed that the agencies should:

- Update the actuarial valuations as of July 1, 2006, three years later than the current valuations. This will allow adjustments for current cost figures and for changes such as the inception of the new Medicare Part D prescription drug benefit.

- Create a trust – perhaps effective July 1, 2007 – if the agency has not already done so. As Mr. Firestine noted, the advantage is a higher rate of investment return, on an actual and actuarial basis, and thus a lower annual required contribution in FY08.
- Assess the costs and benefits of different pre-funding options and make specific recommendations on the extent, timing, and phasing of pre-funding.
- Assess the full range of options for limiting liability, including collective bargaining implications that may vary by agency.
- Use consultant assistance for these tasks that can draw on the growing body of experience from other jurisdictions.
- Provide updates to the Committee at least twice in 2006 – for example, in June and November – and regularly in 2007 until implementation begins on July 1, 2007.
- Design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue.

### **FY07 Operating Budget**

The actuarial valuation done in 2003 showed that the agencies' combined additional annual required contribution, starting in FY08, would be in the range of \$160 million. The new valuation scheduled for completion this year will also show a large number. While the County will not attempt to fund the entire amount in FY08, it will want to take a major first step.

The County's extraordinary revenue surge this year provided the opportunity to make a down payment on this step in FY07, but neither the recommended nor the approved budget did so. Some jurisdictions have acted more firmly to prepare. For example, Baltimore County has set aside \$50 million in FY07 (apart from \$80 million in pay-as-you-go costs) for retiree health benefits. This amount, added to \$50 million already set aside in a health reserve fund, will be placed in trust to defray the county's entire FY08 GASB requirement. The State, New York City, and others have also set aside substantial funds in FY07. (Other jurisdictions have focused instead on limiting future retiree health benefits, as many private sector firms have done.)

### **Agency Updates**

Updates on the work being undertaken by the five County and bi-county agencies – County Government, MCPS, Montgomery College, M-NCPPC, and WSSC – are on ©1-12.

Mr. Firestine's memo on ©1-5 outlines the efforts of County Government. These include forming an interdepartmental working group that has been meeting regularly to define issues and develop a project timeline, formalizing a multi-agency OPEB working group, preparing for an updated actuarial valuation, and participating in the MDGFOA Affinity Group.

The detailed project timeline on ©4-5 is of particular importance, as is Mr. Firestine's suggestion on ©3 that future updates be in the form of a single multi-agency report from the working group. The project timeline includes the following categories: formal trust, budget and funding, plan design options/considerations, actuarial valuations, accounting, and coordination and communication.

Mr. Bowers' letter on ©6-7, Mr. Campbell's letter on ©8-9, Ms. Barney's memo on ©10-11, and Mr. Traber's memo on ©12 also discuss the agencies' work on updated actuarial valuations, trusts, and other issues cited by Mr. Firestine.

**While it appears that the agencies are making good progress on several fronts, the fact remains that GASB Statement 45 takes effect in the fiscal year that starts only one year from now. Moreover, apart from financial reporting, the agencies will start framing initial funding recommendations for FY08 in several months. The agencies clearly have a heavy agenda between now and then, and the Committee's next update, planned for November, will come at a pivotal time.**

For the benefit of readers who have not followed day-to-day developments on this matter, this packet also contains three pieces from the packet for the Committee's November 28, 2005 update that provide excellent background information:

- On ©13-16, a November 23, 2005 *Wall Street Journal* summary of efforts that some governments have already made, ranging from attempts to limit or even eliminate retiree health benefits to the issuance of "OPEB bonds".
- On ©17-21, a June 2005 special report by Fitch Ratings on the credit implications of GASB Statement 45.
- On ©22-27, a July 2005 special comment by Moody's Investors Service that addresses a broad range of funding issues.

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DEPARTMENT OF FINANCE


Douglas M. Duncan  
County Executive

Timothy L. Firestine  
Director

MEMORANDUM

June 15, 2006

TO: Stephen B. Farber, Council Staff Director  
Montgomery County Council

FROM: Timothy L. Firestine, Director  
Department of Finance 

SUBJECT: OPEB Update

The purpose of this letter is to respond to your request for an update on the County Government's activities related to GASB Statement 45, Financial Reporting for Other Post-employment Benefits (OPEB).

In order to assure timely implementation and coordination, the Department of Finance has created a project timeline that includes tasks and milestones related to the administrative aspects of the OPEB project. The major task categories include actuarial valuation process, trust creation, budgeting/funding, plan design options/considerations, accounting, and coordination/communication. The steps necessary for completing each major task are identified and the timeline for completing those steps is mapped. A copy of the project timeline is attached.

In addition to creating the project timeline, an internal County Government workgroup was formalized. The work group includes representatives from the Department of Finance, Office of Human Resources, Office of Management and Budget, and Office of the County Attorney. The work group has met several times since the November MFP Committee meeting. The work group has focused its agendas on ensuring the completeness of, approving, and periodically updating the project timeline, organizing work related to updating the actuarial valuation, identifying issues for legal consideration, and identifying opportunities for County multi-agency coordination and collaboration. The workgroup has also actively participated in the MDGFOA OPEB Affinity Group, through which we share information between other local Phase 1 governments (those required to implement by the same deadline as the County agencies) on approach, issues, and internal progress toward implementation. Another focus of this work group has been to stay abreast of clarifying guidance being issued by GASB and to work to determine its impact on the County's efforts.



Office of the Director

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Stephen B. Farber  
June 15, 2006

In response to your request for information on progress related to the steps identified at the MFP meeting last November, the most substantial progress relates to updating the actuarial valuation. The County has selected an actuary to provide the OPEB valuation and held initial discussions to identify the scope of an initial updated valuation and identify issues that have required follow-up. For example, issues arose during the planning processes that have required additional clarification from GASB. As part of planning for the valuation, the workgroup has identified scenario options that are being incorporated into the valuation process, such as alternative funding phase-in options and alternative actuarial assumptions and methodologies. The updated valuation will also include expanded information beyond that included in the original valuation, such as a breakout of the annual required contribution attributable to County government, as plan sponsor employer, vs. the other agencies that participate in the County plan. The County is currently working with the actuary to finalize the assumptions the actuary is using in the valuation. It is expected that the updated valuation will be available later this summer. This timing is currently several months later than the originally planned goal; however, the workgroup is working with the actuary to identify opportunities for work relating to plan design and legal considerations to be conducted simultaneously, rather than sequentially, over the summer.

Also, to continue the interagency coordination on this subject you started several years ago, a multi-agency OPEB workgroup has been formalized. This group met a few weeks ago and was attended by 12 representatives from the various agencies of the County. The objectives covered at this first meeting included:

- Communicating agencies' status and planned next steps;
- Identifying information needed for FY 08 and multi-year fiscal planning/budgeting;
- Identifying opportunities for comparability of data based on consistency of valuation assumptions; and,
- Identifying next steps, including multi-agency coordination.

As I'm sure you will see from the responses from the various agencies to your request for an update for the MFP Committee meeting, most agencies have been working on updating their actuarial valuations. One of the results of the recently held meeting was to identify areas where agencies could try and achieve consistencies in the assumptions and funding scenarios incorporated into its updated valuations, and to start to identify areas where there may be valid reasons for inconsistencies. The group plans on meeting again in late August to start to review agencies' updated valuations from a fiscal planning perspective, and further identify those areas where there are valid reasons for different assumptions used across the agencies.

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Stephen B. Farber  
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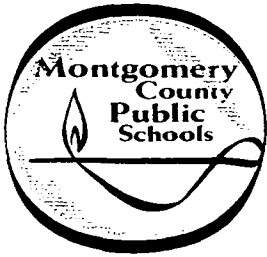
The County looks forward to working with the Council on this topic of significant impact to state and local governments, and suggests that future updates to the Council be accomplished in a single multi-agency report coordinated through the Workgroup.

Attachment

ID	Task Name	Duration	Start	Finish
1				
2	<b>Formal Trust</b>	<b>357 days?</b>	<b>Wed 3/1/06</b>	<b>Sat 6/30/07</b>
3	Identify/Evaluate Options & Impact (not FY07)	65 days?	Wed 3/1/06	Tue 5/30/06
4	Staff Recommendations re Options	22 days?	Thu 6/1/06	Fri 6/30/06
5	Management Policy Recommendations	20 days?	Mon 7/3/06	Fri 7/28/06
6	Implement - create trust document (IA) (goal: 3/15 budget date)	167 days?	Tue 8/1/06	Tue 3/13/07
7	Implement - create/amend laws - County (goal: 3/15 budget date)	165 days?	Tue 8/1/06	Fri 3/9/07
8	Implement - create/amend laws - State (goal: FY07 legislative session)	64 days?	Thu 1/11/07	Tue 4/10/07
9	Deadline - trust to be in place if applicable (for FY08 effective yr)	0 days	Sat 6/30/07	Sat 6/30/07
10				
11	<b>Budget/Funding</b>	<b>317 days?</b>	<b>Mon 3/27/06</b>	<b>Thu 5/31/07</b>
12	Obtain updated baseline valuation (scope of report to be determined) - A	26 days?	Mon 3/27/06	Mon 5/1/06
13	Perform analysis over valuation (ie, non-tax supp rate impact) & options (ie, funding period)	22 days?	Tue 5/2/06	Wed 5/31/06
14	Obtain actuarial estimates re: cost/plan design options - B	94 days?	Mon 3/27/06	Tue 8/1/06
15	Staff Recommendations re Options	22 days?	Thu 6/1/06	Fri 6/30/06
16	Management Policy Recommendations	22 days?	Sun 7/2/06	Mon 7/31/06
17	Implement - Obtain ongoing assistance as needed - C	46 days?	Tue 8/1/06	Sun 10/1/06
18	Obtain updated actuarial valuations from other Council-funded/approved agencies - M	14 days?	Mon 8/14/06	Thu 8/31/06
19	Consider need for update for final FY06 valuation for budget planning purposes - D	45 days?	Mon 10/2/06	Wed 11/29/06
20	Implement - Incorporate initial estimate to Budget Process and fiscal plan - FY08 - E	11 days?	Thu 11/30/06	Wed 12/13/06
21	Implement - Update budget estimates when FY06 valuation available	7 days?	Sun 10/1/06	Sat 10/7/06
22	Brief new CCand CE (part of budget process?) - G	22 days?	Fri 12/8/06	Fri 1/5/07
23	Development of FY08 Recommended Budget - pre new CE	80 days?	Fri 8/18/06	Fri 12/1/06
24	Development of FY08 Recommended Budget - post new CE	75 days?	Sat 12/2/06	Wed 3/14/07
25	Consideration by CE of Funding Options (part of budget process)	75 days?	Sat 12/2/06	Wed 3/14/07
26	Consideration by CE of Plan Design Options - I	75 days?	Sat 12/2/06	Wed 3/14/07
27	Deadline - FY08 CE Recommended Budget Published	0 days	Thu 3/15/07	Thu 3/15/07
28	Development of Final FY08 Budget Adopted by Council	54 days?	Mon 3/19/07	Wed 5/30/07
29	Est Deadline - FY08 Council Approved Budget	0 days	Thu 5/31/07	Thu 5/31/07
30				
31	<b>Plan Design Options/Considerations</b>	<b>696 days?</b>	<b>Wed 3/1/06</b>	<b>Wed 10/8/08</b>
32	Identify/Evaluate Options & Impact	65 days?	Wed 3/1/06	Tue 5/30/06
33	Obtain actuarial estimates re: cost/plan design options - B	94 days?	Mon 3/27/06	Tue 8/1/06
34	Determination of involvement/role of others (legal counsel, unions, etc)	65 days?	Wed 3/1/06	Tue 5/30/06
35	Normal annual plan design/redesign considerations & tie-in to GASB work	91 days?	Mon 5/1/06	Thu 8/31/06
36	Staff Recommendations re Options	22 days?	Thu 6/1/06	Fri 6/30/06
37	Initial Management Policy Recommendations	22 days?	Sun 7/2/06	Mon 7/31/06
38	Implement - Obtain ongoing assistance as needed - C	46 days?	Tue 8/1/06	Sun 10/1/06
39	FY08 annual rate-setting process	42 days?	Mon 8/14/06	Fri 10/6/06
40	Consideration by CE of Plan Design Options - I	75 days?	Sat 12/2/06	Wed 3/14/07
41	Obtain FY08 actuarial valuation - J	67 days?	Tue 7/1/08	Wed 10/1/08
42	Implement - Updated actuarial valuation	21 days?	Sat 12/2/06	Fri 12/29/06

ID	Task Name	Duration	Start	Finish
43	Implement - Incorporate to OHR contracting processes (assumes 1/1/08 effective date)	45 days?	Wed 8/1/07	Mon 10/1/07
44	Implement - Incorporate to future budgeting processes	165 days?	Thu 8/2/07	Sat 3/15/08
45	Implement - Incorporate final disclosures to FY08 F/S - K	5 days?	Thu 10/2/08	Wed 10/8/08
46	Future ongoing considerations??	1 day?	Wed 3/1/06	Wed 3/1/06
47				
48	<b>Actuarial Valuations</b>	<b>678 days?</b>	<b>Mon 3/27/06</b>	<b>Wed 10/8/08</b>
49	Conduct kickoff meeting with actuary and County	11 days?	Wed 3/29/06	Wed 4/12/06
50	Obtain updated baseline valuation (scope of report to be determined) - A	47 days?	Mon 3/27/06	Tue 5/30/06
51	Obtain actuarial estimates re: cost/plan design options - B	94 days?	Mon 3/27/06	Tue 8/1/06
52	Implement - Obtain ongoing assistance as needed - C	46 days?	Tue 8/1/06	Sun 10/1/06
53	Consider need for update for final FY06 valuation for budget planning purposes - D	45 days?	Tue 8/1/06	Sat 9/30/06
54	Implement - Incorporate initial estimate to Budget Process and fiscal plan - FY08 - E	11 days?	Sun 10/1/06	Thu 10/12/06
55	Obtain FY08 actuarial valuation - K	67 days?	Tue 7/1/08	Wed 10/1/08
56	Implement - Incorporate to financial statements (for FY08 from FY08?) - L	5 days?	Thu 10/2/08	Wed 10/8/08
57				
58	<b>Accounting</b>	<b>583 days?</b>	<b>Thu 8/3/06</b>	<b>Wed 10/8/08</b>
59	Determine F/S impact of trust and funding policy decisions	167 days?	Thu 8/3/06	Thu 3/15/07
60	Determine F/S impact of any creation or amendment to laws	185 days?	Thu 8/3/06	Tue 4/10/07
61	Implement - fund/general ledger changes	244 days?	Fri 8/4/06	Sat 6/30/07
62	Obtain FY08 actuarial valuation - K	67 days?	Tue 7/1/08	Wed 10/1/08
63	Implement - Incorporate final disclosures to FY08 F/S - L	5 days?	Thu 10/2/08	Wed 10/8/08
64				
65	<b>Coordination/Communication</b>	<b>358 days?</b>	<b>Wed 3/1/06</b>	<b>Sat 6/30/07</b>
66	<b>Coordination/consultation with other Council-funded/approved agencies</b>	<b>291 days?</b>	<b>Wed 3/1/06</b>	<b>Fri 3/30/07</b>
67	Planning (valuation timing, consistent funding assumptions, etc)	66 days?	Wed 3/1/06	Wed 5/31/06
68	Obtain updated actuarial valuations from other Council-funded/approved agencies - M	14 days?	Mon 8/14/06	Thu 8/31/06
69	Meet with interagency OPEB Workgroup to review address results of updated valuations	15 days?	Mon 8/21/06	Fri 9/8/06
70	Periodic (estimated)	22 days?	Fri 12/1/06	Fri 12/29/06
71	Periodic (estimated)	22 days?	Thu 3/1/07	Fri 3/30/07
72	Participating agencies - planning - rates/budget & accounting - prelim est	45 days?	Tue 8/1/06	Sat 9/30/06
73	Participating agencies - update based on CE rec budget	22 days?	Fri 3/16/07	Sun 4/15/07
74	Participating agencies - update based on CC approved budget	22 days?	Fri 6/1/07	Sat 6/30/07
75	Departs - enterprise/int svc - planning - rates/budget & accounting	45 days?	Tue 8/1/06	Sat 9/30/06
76	Departs - enterprise/int svc - update for FY06 valuation - rates/budget & accounting	7 days?	Sun 10/1/06	Sat 10/7/06
77	Depts - enterprise/int svc - final impact based on CC approved budget	57 days?	Thu 3/15/07	Thu 5/31/07
78	Departments - as part of normal budget process??	124 days?	Sun 10/1/06	Thu 3/15/07
79	Others?	1 day?	Wed 3/1/06	Wed 3/1/06





850 Hungerford Drive \* Rockville, Maryland \* 20850-1747

Telephone (301) 279-3626

June 12, 2006

Mr. Steve Farber, Staff Director  
Montgomery County Council  
100 Maryland Avenue  
Rockville, Maryland 20850

Dear Mr. Farber:

This letter is in response to your May 3, 2006, request for an update on the Governmental Accounting Standards Board (GASB) Statement Number 45, Financial Reporting for Other Post-employment Benefits (OPEB) which requires governmental agencies to disclose the liability for the cost of health benefits current employees and retirees will receive during retirement. This disclosure requirement was originally targeted for implementation in FY 2006; however, implementation has been delayed to FY 2008.

At the November 28, 2005, meeting of the County Council's Management and Fiscal Policy (MFP) Committee, it was agreed that several steps would be taken by County agencies over the coming months. We welcome the opportunity to update the MFP Committee on the status of these efforts.

The Montgomery County Public Schools (MCPS) is working with its actuary to prepare a new valuation, effective July 1, 2006. The valuation will include analysis of current demographics, plan design, and cost-sharing arrangements. MCPS has been working with other county and bi-county agencies to ensure there is consistency across agencies in methodology, process, timelines, and assumptions used. Agencies will consider common funding options and amortization methods, and will, to the extent possible, use a common approach for evaluating trend data. The agencies also are developing a plan to share data and report back to the MFP Committee.

The valuation also will look at the impact of the Medicare Part D prescription drug benefit that went into effect January 1, 2006. It should be noted that MCPS has opted to receive a subsidy from the Center for Medicare and Medicaid Services (CMS) as reimbursement for providing prescription drug benefits to Medicare eligible retirees. We have been advised that the GASB voted last week to finalize GASB's proposed technical bulletin, which will not allow MCPS to net out the subsidy payments and report reduced retiree medical liabilities when we adopt GASB Statement 45.

Finally, MCPS has begun discussions with legal counsel to explore options with respect to the possible need to establish a trust arrangement to manage funding our GASB liabilities.

Montgomery County needs to address the issues of Other Post-employment Benefits funding as part of its overall financial planning. MCPS continues to work closely with the County Council and county agencies to address this issue cooperatively. MCPS staff will be present at the June 26, 2006, Management and Fiscal Policy Committee meeting.

Sincerely,



Larry A. Bowers  
Chief Operating Officer

LAB:

Copy to:

Members of the County Council  
Members of the Board of Education  
Dr. Weast  
Mrs. DeGraba  
Mr. Doody  
Mr. Girling  
Dr. Spatz

June 7, 2006

Mr. Steve Farber  
Montgomery County Council Staff Director  
100 Maryland Avenue  
Rockville, MD 20850

Dear Mr. Farber:

This letter is in response to your request of May 3, 2006 for an update on the Governmental Accounting Standards Board Statement Number 45, Financial Reporting for Other Post-employment Benefits (OPEB). This statement requires governmental agencies to disclose the liability for the cost of health benefits current employees and retirees will be eligible to receive during retirement. At the Management and Fiscal Policy Committee meeting in November 2005, it was agreed that the following steps appeared to make sense:

- Update the actuarial valuations as of July 1, 2006, three years later than the current valuations. This would allow adjustments for current cost figures and for changes such as the inception of the new Medicare Part D prescription drug benefit.
- Create a trust – perhaps effective July 1, 2007 – if the agency has not already done so. As Mr. Firestone notes, the advantage is a higher rate of investment return, on an actual and actuarial basis, and thus lower annual required contributions in FY08.
- Assess the costs and benefits of different pre-funding options and make specific recommendations on the extent, timing, and phasing of pre-funding.
- Assess the full range of options for limiting liability, including collective bargaining implications that may vary by agency.
- Use consulting assistance for these tasks that can draw on the growing body of experience from other jurisdictions. (Apart from the consultants used by the individual agencies, the Council has in the past received expert assistance on interagency health benefits issues from Bolton Partners.)
- Provide updates to the Committee at least twice in 2006 – for example, in June and November – and regularly in 2007 until implementation begins on July 1, 2007.
- Design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue.

As you are aware, the College had previously decided to comply with FAS106 beginning in FY94. As a result funds had been set aside to the extent possible until FY04. We have continued to have annual valuations to determine our accrued actuarial liability since then. We will be having a FAS106 calculation to determine our June 30, 2006 Accumulated Post-Retirement Benefit Obligation (APBO) as well as an estimate of what our liability might be under GASB standards. We also have met with AON Consultants to discuss the implications of establishing a trust effective July 1, 2007. While there are still some questions to be answered, it appears there are many favorable aspects to be gained by the establishment of a trust for the GASB funding.

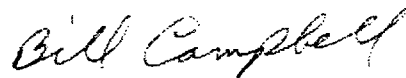
Mr. Steve Farber  
Page 2

We continue to support the position that pre-funding to the greatest extent possible is the most prudent approach to take. In light of this expectation, the College hopes to be able to set aside some budgeted FY06 benefits funds that might be available as of June 30, 2006.

We also are reviewing our current retiree group insurance coverage eligibility requirements to determine what changes might be made to limit our future liability. We believe there are some options to consider. Our Office of Human Resources has been working with our consultants as well as participating in several informative educational opportunities on the implications and impact of GASB Statement 45. We also find the continued communication among all of the agencies benefits professionals to be extremely beneficial for assessing all aspects of the effect GASB 45 will have on all of us.

We look forward to our continued discussions and will be present at the June 26 worksession with the MFP Committee and our colleagues from the County-funded agencies.

Sincerely,



William E. Campbell  
Executive Vice President  
for Administrative and Fiscal Services

cc: Ms. Lawyer  
Mr. Moore  
Mr. Mullinix  
Ms. von Bargaen

**THE MARYLAND-NATIONAL CAPITAL PARK & PLANNING COMMISSION**  
***Department of Finance, Office of Secretary-Treasurer***

PCB06-35  
June 14, 2006

TO: Management and Fiscal Policy Committee

FROM: Patricia Colihan Barney, Secretary-Treasurer *PCB*

SUBJECT: Update on M-NCPPC Other Post Employment Benefits (OPEB) –  
response to GASB Statement No. 45

**BACKGROUND:** Per your request, this memo provides an update of the status of work related to implementing the Governmental Accounting Standards Board Statement Number 45, Financial Reporting for Other Post Employment Benefits. These benefits include medical, dental, and life insurance benefits at the Maryland-National Capital Park and Planning Commission.

One of the action items discussed at the November 2005 Management and Fiscal Policy Committee meeting related to the creation of a trust. The Commission established a 115 Trust in July of 1999. At the end of fiscal year 2005, after various contributions and withdrawals, the fund was almost depleted. The Commission decided to retain a small balance to keep the 115 Trust Fund open and ready to receive pre-funding contributions at a future date.

**CURRENT STATUS:** The Commission has been working with Aon Consulting to compare Commission OPEB with benefits offered by other governmental agencies. This study includes looking at alternatives offered to retirees by other agencies, examining possibilities of different levels of OPEB based on years of service, and benchmarking these various alternatives to estimate cost impacts. Commission Management is currently reviewing the consultant's report. Any proposed changes will be presented to the Commissioners in late fall.

Concurrently, we are pursuing the engagement of an actuary by riding a current contract. The selected actuary will perform a valuation as of July 1, 2006 to include the impact of Medicare Part D (if GASB's pending Technical Bulletin allows) and the requirement for consideration of implicit subsidies not included in the prior study. We will also look at

recording of a liability on the entity-wide financial statements of an amount equal to any unfunded required annual contribution beginning in fiscal year 2008. We are aware that the rating agencies will be looking for plans to be in place to address the pre-funding issue. It should be noted that the Prince George's County side of the Commission has factored in full annual pre-funding requirements in its long-term fiscal plan. The Commission will continue to work with the Montgomery County agencies to review a series of recommended strategies for pre-funding retiree medical.

The Commission's Finance Department has briefed the Commissioners on GASB Statement No. 45 so they will be informed as we move forward with both counties in determining how to establish a plan to address this issue. The Commission has not adopted a formal policy on pre-funding strategies. A series of recommendations will likely proceed to them after staff review of the Aon study.

V:\Update on MNCPPC OPEB-6\_2006

# WASHINGTON SUBURBAN SANITARY COMMISSION

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## Memorandum

**TO:** STEVE FARBER  
MONTGOMERY COUNTY COUNCIL STAFF DIRECTOR

**FROM:** TOM TRABER  
WSSC CHIEF FINANCIAL OFFICER

**DATE:** JUNE 13, 2006

**SUBJECT:** GASB 45 STATUS

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Since last November, we have done the following with regards to implementing GASB 45:

- Our Commissioners were briefed on GASB 45 in February. This briefing was a high-level view of the pronouncement and its implications for WSSC and other governmental agencies.
- Aon prepared a June 30, 2005 actuarial valuation of OPEB in March. We are currently evaluating its results.
- A legal opinion as to whether WSSC can establish a trust under the current provisions of Article 29 of the Annotated Code of Maryland has been requested from outside counsel. If we do not have legislated authority, and the Commission determines that a trust is the appropriate vehicle for compliance, we would be submitting legislation in the upcoming legislative session.
- We have continued to participate with the Montgomery County Working Group in sharing information. It is very beneficial to have a feel for the specific plans that local agencies are making.
- Staff has also attended several briefings on GASB 45 by Aon, the Maryland Government Finance Officers' Association, and others.

Looking ahead, we anticipate having our implementation plan ready for Commissioner review by September and incorporating OPEB funding into the FY 2008 Spending Affordability process.

We look forward to continued participation with the Working Group and sharing our progress with the MFP Committee on June 26<sup>th</sup>.



November 23, 2005

## State, Local Officials Face Looming Health-Care Tab

**Rule Requiring Disclosure  
Of Obligations to Retirees  
Could Force Painful Choices**

**By DEBORAH SOLOMON**  
Staff Reporter of THE WALL STREET JOURNAL.  
*November 23, 2005; Page A1*

A looming accounting change is forcing state and local governments to fess up to something that's been lurking on their books for years: Many have made costly retirement health-care promises without planning how to pay for them.

Under a new accounting rule, governments soon must start recognizing their long-term obligations to pay for retirees' health benefits -- and, for the first time, publicly disclose what it would cost each year to fund that liability.

For many governments, the promised amount is likely to be sizeable enough to prompt big changes such as cutting retiree benefits, borrowing money and diverting tax dollars from other spending priorities -- or risk a credit-rating downgrade that could significantly boost borrowing costs. Estimates of obligations for some states range from \$500 million to as much as \$40 billion.

"This is going to be a big jolt to many state budgets, and this problem is one that is not immediately resolved," said Cecilia Januszkiewicz, secretary of Maryland's department of budget and management.

In many ways, the problem facing state and local governments mirrors that which has faced some companies, especially in labor-intensive, unionized industries such as autos and steel, which made big promises on pensions and health care that they ultimately couldn't afford to fund. Many governments are expected to respond in much the same way as corporations, which have slashed benefits since being forced in 1990 to recognize their retiree health-care obligations in financial statements.

But the dilemma for governments may be even thornier. Most states are legally required to provide some form of employee and retiree benefits for government workers, and changing or doing away with those benefits usually requires legislative action. While some local municipalities have more flexibility to change benefits, others must work through their state legislatures. In contrast, most public companies can easily trim benefits, especially those with weak or no union representation.

Cutting benefits for government workers is especially tough given that many employees are protected by strong unions that will challenge any such efforts. While unions representing workers in the private sector have lost significant clout, the municipal and



state unions remain quite strong. Additionally, while public companies can fall back on the Pension Benefit Guaranty Corp., which insures corporate pension funds, for some of the burden, governments have no such option.

So far, no state or local government has actually defaulted on any of its benefit plans. And the new rule doesn't require governments to set aside any money to fund the long-term obligations -- only to report what those obligations are.

But the change will shed new light on their long-term liabilities. And credit-ratings companies have told governments they expect the retiree health-care liability to be dealt with in some fashion. "We're looking to see that governments don't ignore it and look to control the growth of the obligation," said Richard Raphael, an analyst with Fitch Ratings.

How the ratings agencies respond will have big consequences for local and state governments, which borrow heavily from the public markets and need to maintain good ratings to keep borrowing rates low.

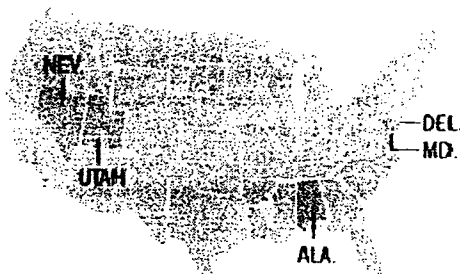
The accounting change will affect most big governments starting in fiscal 2008, which generally begins on July 1, 2007. It stems from a rule passed last year by the Government Accounting Standards Board, the independent advisory board that sets accounting standards for state and local governments.

With less than two years until the rule takes effect, governments already are scrambling to determine what they've promised to pay for retiree health care over the next 30 years -- and how to fund that liability. Until now, health-care benefits have been recorded on a pay-as-you-go basis, with budgets reflecting only the actual expense of benefits paid to employees and retirees each year.

Some already have gotten a taste of the bad news. Last month, Maryland disclosed a retiree-health-care liability of \$20 billion, and said it must put aside \$1.6 billion annually to fund the obligation. That's about 13% of the state's \$12 billion general fund and comes on top of the \$770 million Maryland shells out each year to pay for employee and retiree health-care benefits.

## Scaling Back?

State and local governments are looking to curb escalating retiree health-care costs, which will come into view as the result of a pending accounting change. Here's a look at what several states are doing to respond to their long-term health-care liability:



Maryland	Alabama	Delaware	Nevada	Utah
<b>ESTIMATED HEALTH-CARE LIABILITY:</b>				
<b>\$20.0 billion</b>	<b>10.9</b>	<b>3.0</b>	<b>1.75-4.40</b>	<b>0.54</b>
<b>ACTIONS TAKEN:</b> Established a task force to explore ways to address health-care obligations	Increased health-care premiums for state employees who smoke; increased health-care costs for state employees who retire before 25 years of service	Committee established to review benefits unable to produce consensus around a single option or combination of options	Rejected a bill to end retiree health-care benefits for any state government employee hired after July 1, 2006	Passed legislation to end practice of allowing state employees to exchange eight hours of sick leave for one month's worth of retirement medical coverage

Source: Moody's Investors Service

Ms. Januszkiewicz said the \$20 billion obligation was much higher than the \$3 billion to \$5 billion officials had been anticipating, and will force the state to make some hard choices.

"When I got the

number I was in shock," said Ms. Januszkiewicz, adding that "there are a limited number of things we can do." A task force created by the state General Assembly earlier this year is examining the obligation and will make recommendations on how to deal with it.

The change comes at a time when many state and local governments already are struggling with other costs, such as fully funding their employee pension plans, which face shortfalls of as much as \$300 billion nationwide. Some are still recovering from the recession early this decade, which dented capital-gains and income taxes and caused a shortfall in revenue. In fiscal 2002, states suffered their steepest revenue drop since the Depression, said Mr. Raphael.

"States are coming off their worst fiscal crisis in decades," said Sujit CanagaRetna, a senior fiscal analyst with the Council of State Governments. "They're not really flush with funds and it's still a dire revenue picture as far as expenditures needed down the road."

Indeed, the situation is similar to the problems facing government-employee pension plans. Officials often promised big benefits but failed to set aside enough money to fund them, preferring during the 1990s to focus on outsized investment gains which eventually disappeared. The city of San Diego, for instance, is facing a \$1.1 billion pension shortfall in part because of agreements it made to sweeten benefits in exchange for reduced payments into the pension fund.

The problem has been years in the making. State and local governments began heavily expanding in the 1960s for a number of reasons, including the need for more schools as the Baby Boomers grew up and a heavier load of federal mandates, such as the 1965 Medicare law. As the number of employees grew, so did the cost of providing them benefits.

At the same time, the strength of public employees grew in tandem with the power of the American Federation of State, County and Municipal Employees, which represents public

workers. By the end of 1965, AFSCME had won collective-bargaining rights in several states, which translated into better and more generous benefits. And even with some recent cutbacks, costs are expected to swell over the next few years as the Baby Boomers begin to retire and collect both pension and health-care benefits.

For local officials, the latest dilemma could mean taking some politically unpopular stands. In Nevada, a proposal by Republican Gov. Kenny Guinn to discontinue retiree health-care benefits for any state government employee hired after July 1, 2006, ignited a firestorm.

The proposal was estimated to save the state \$500 million per year, but the state's employee union lobbied aggressively to scotch the legislation, and it failed in the Democratic-controlled state assembly. Nevada has estimated its retiree-health-care obligation to be as high as \$4.4 billion and says it will need to put aside about \$200 million annually to fund the liability.

Scott Mackenzie, executive director for the State of Nevada Employees Association, said unions understand that governments need to cut costs, but that ending benefits will turn people away from civil service, where robust benefits often make up for lower salaries.

"Government attracts people because they have a bit of a cushion there when they retire," said Mr. Mackenzie.

Other states have been unable to reach consensus on how to address the liability. A committee established earlier this year by Delaware Gov. Ruth Ann Minner, a Democrat, explored various ways to address the state's estimated \$3 billion obligation and the \$185 million it needs to set aside annually. The committee looked at a range of options, including reducing the state's agreement to pay 100% of health insurance for retirees, but was unable to agree on a plan. "Without exception, the options presented to the Committee included difficult and unavoidable policy trade-offs," the report concluded. "There are no straightforward 'win-win' solutions."

Some governments are opting to sell debt to finance their health-care obligation. For instance, Gainesville, Fla., issued bonds earlier this year to help finance its \$30.6 million liability.

Others are trimming benefits, despite the political ramifications. The city of Arlington, Texas, recently did away with retiree health benefits for any employee hired after 2006 and trimmed the percentage of health-care costs that the city covers. Arlington Chief Financial Officer Donna Swarb said the moves cut the city's health-care obligation to \$150 million from \$196 million. However, a more controversial plan to charge premiums based on age wasn't adopted and the city is still facing costs that Ms. Swarb called "unmanageable."

Alabama, Utah and Ohio also have taken steps to scale back benefits, including raising health-care premiums for retirees and increasing the length of time employees must work before being eligible for retiree health care.

Other states, such as California and New York, have yet to officially determine their liabilities but policy watchers and credit-ratings analysts expect those numbers will be significant. Some have predicted that California's obligation could be \$40 billion or more. The state controller's office has requested money from the governor and Legislature to perform an assessment of the liability.

## Special Report

## The Not So Golden Years

### Credit Implications of GASB 45

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*The authors wish to thank finance department staff at Montgomery County, MD for sharing the results of a preliminary study of the county's OPEB liabilities, which provided valuable context to this report.*

#### Related Research

- "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Sept. 18, 2003
- "Local Governments Pressured by Rising Employee Health Care Costs," Dec. 13, 2004

#### ■ Summary

A new public sector accounting standard touches on three hot topics: skyrocketing health care costs, the ongoing national debate over retirement security, and the recent emphasis on greater financial disclosure. Governmental Accounting Standards Board (GASB) Statement No. 45 relates to other post-employment benefits (OPEB) — payments and services provided for retirees other than pensions. OPEB consist mainly of retiree health care benefits. GASB 45 applies the accounting methodology used for pension liabilities (GASB 27) to OPEB and is similar in concept to an accounting standard adopted for the private sector in the mid-1990s.

The new standard, to be implemented beginning in fiscal 2008 for many large governments, is timely given the aging demographics of the governmental work force. It also reflects the consistent efforts of the GASB to improve financial statement transparency and align public accounting more closely with that of the private sector.

GASB 45 does not increase costs of employment, but attempts to more fully reveal them by requiring governmental units to include future OPEB costs in their financial statements. Under current practice, nearly all governments pay only the cost of OPEB due in the current year, with no effort made to accumulate assets to offset future benefit costs. While not mandating funding, GASB 45 does establish a framework for prefunding of future costs.

Amounts required to prefund OPEB on an actuarially sound basis are likely to significantly exceed annual pay-as-you-go outlays for these benefits. Many actuaries believe, bolstered by preliminary studies done on behalf of a few proactive governments, that actuarially determined annual contributions could be five to 10 times higher than current expenses in many cases.

Fitch Ratings views GASB 45 as a positive step toward more fully illuminating governmental obligations to retirees, but acknowledges the inherent tension between allocating scarce resources toward critical government services today and meeting the funding requirements for retirement benefits that might not be due for decades. Fitch anticipates that governments will thoroughly review retiree benefit programs and that responses to OPEB funding challenges will vary considerably. However, Fitch expects many governments will approach GASB 45 in much the same way they responded to the adoption of pension system actuarial and accounting standards, by steadily ramping up annual contributions to actuarially determined levels, altering benefit plans, or taking other actions to ensure long-term plan solvency.

### Credit Highlights

- Governmental Accounting Standards Board (GASB) Statement No. 45 will be the accepted accounting practice for governments as of its implementation dates. Failure to comply would prevent auditors from releasing a "clean" audit opinion.
- The switch to actuarial funding from a pay-as-you-go practice may have a sizable fiscal impact. However, Fitch Ratings believes that meeting actuarial funding requirements for other post-employment benefits (OPEB) will be a stabilizing factor and protective of credit over time.
- Fitch expects a wide range of unfunded liability positions to result as GASB 45 is implemented, reflecting the variability of benefits offered around the U.S. Annually required contributions are likely to place disparate burdens on the budgetary resources of state and local governments.
- Initially, Fitch's credit focus will be on understanding each issuer's liability and its plans for addressing it. Fitch also will review an entity's reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.
- For issuers choosing to ramp up annual contributions to reach full funding of actuarially determined levels, Fitch recognizes that a rising net OPEB obligation in the short term may be a by-product. Such an increase, taken in the context of a sound OPEB funding plan, will not by itself affect credit ratings.
- Fitch does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality.
- Assumptions play a crucial role in calculating plan assets and liabilities. As actuarial standards for OPEB plans become clear, Fitch will review the underlying assumptions and will view negatively any that are overly aggressive. When applicable, assumptions should be consistent with those adopted for the plan sponsor's pension system.
- Fitch will view OPEB liabilities, like pensions, as soft liabilities that fluctuate based on assumptions and actual experience. Reality dictates that an entity may opt to defer OPEB funding in times of budget stress. However, indefinite deferrals are damaging to credit quality. While not debt, pension and OPEB accumulated costs are legal or practical contractual commitments that form a portion of fixed costs. Long-term deferral of such obligations is a sign of fiscal stress that will be reflected in ratings.

Failure to make actuarially determined OPEB plan contributions will most likely result in rising net OPEB obligations, which like rising net pension obligations are a deferral of financial responsibility. Therefore, over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer's credit rating. Conversely, in Fitch's opinion, the prudent accumulation of assets in a trust account outside the general fund and well in advance of pay-as-you-go cost escalations can avoid or forestall liquidity problems or tax capacity concerns that might lead to credit deterioration.

### ■ Implementation Schedule

GASB 45 will be phased in, beginning with the largest governments, effective:

- Fiscal periods beginning after Dec. 15, 2006 for governments with annual revenue greater than \$100 million.

- Fiscal periods beginning after Dec. 15, 2007 for governments with annual revenue between \$10 million and \$100 million.
- Fiscal periods beginning after Dec. 15, 2008 for governments with revenue under \$10 million.

### ■ Exploring GASB 45

GASB 45 furthers the effort to disclose the total cost of compensation earned by public sector employees. Some of this cost, specifically the salaries and related benefits of active workers, is already recognized on the statement of revenues, expenditures, and changes in fund balance (income statement) prepared annually. Similarly, the cost of pension benefits for current and retired workers is recognized through the implementation of GASB 27, which requires income statement recognition of annual employer contributions to pension systems and balance sheet recognition of net pension obligations (most often as a liability, but theoretically an asset). GASB 45 largely adopts the accounting and

actuarial valuation methodologies used for pensions, making minor adjustments to reflect the different nature of OPEB and the reality that very few governments have funded OPEB plans.

OPEB primarily relate to retiree health care, but can also include life insurance and other benefits. OPEB contributions by employers generally take the form of direct indemnity payments or full or partial cost-sharing of annual insurance premiums, but can also take the form of an implicit subsidy. This occurs when retirees pay a health insurance premium that is based on a larger risk pool, thereby benefiting from a lower premium rate than if they had to pay the full age-based premium.

Under GASB 45, governments providing benefits to more than 200 plan members are required to have an actuarial valuation of their OPEB plans done every two years. Most governments accessing the capital markets fall under this requirement. The OPEB plan is defined as whatever constitutes the "substantive plan," incorporating written and documented plan elements, as well as nondocumented elements that have been communicated and understood between the employer and employees. The actuarial valuation determines the actuarial present value of future liabilities — in essence, the amount that, if invested at the valuation date, would be sufficient to meet all liabilities, assuming embedded assumptions hold true.

From the actuarial valuation, an annually required contribution (ARC) is determined. The ARC is the portion allocated to the current year of the amount needed to pay both the normal costs (current and future benefits earned) and to amortize the unfunded liability (past benefits earned but not previously provided for). GASB 45 requires amortization of unfunded liabilities over a maximum of 30 years.

GASB 45 requires an accounting of a government's compliance in meeting its ARC. Contributions in an amount less than the ARC result in a net OPEB obligation, which is to be recorded as a liability on the governmentwide financial statements and full accrual-based fund statements. Only the employer's payments count toward the ARC; employee matching payments do not. The direct payment of benefits counts as a contribution toward the ARC. However, since nearly all plans will have some past service liability to amortize, simply continuing with pay-as-you-go funding is likely to result in rising net OPEB obligations.

Unlike GASB 27, which covers employer accounting for pensions, under GASB 45 there will be no net OPEB obligations reported at transition (unless a government volunteers to record one). Unfunded OPEB plan liabilities will be present as governments begin to implement the standard, but governments will be required to disclose their compliance in meeting the ARC only on a going-forward basis. The footnotes to the financial statements will include information on compliance in meeting ARCs, the cumulative net OPEB obligation, and the actuarial funding ratio of the OPEB plan (assuming a trust account is established).

### ■ OPEB Trust Funds

A critical element to making OPEB plans affordable and actuarially sound is GASB 45's requirement that, in order for actuaries to permit the use of a long-term investment return assumption, governments must set aside plan assets in an irrevocable trust. Funds accumulated or earmarked but held outside an irrevocable trust are limited to an investment return assumption consistent with general government investments, which are typically shorter in duration and lower in yield. Partially funded plans are required to use a blended rate, based on the proportion of contributions being used for asset accumulation versus payment of current benefits.

The ramifications for OPEB plan valuation are enormous, as long-term return assumptions are usually at least twice those of short-term investments. The higher the investment return assumption (discount rate), the lower the present value of future liabilities and the corresponding ARC will be.

Governments and actuaries are currently exploring different types of trust mechanisms, with no clear consensus emerging to date. Options include 401(h) accounts, voluntary employee benefit accounts, section 115 governmental trusts, and others. The type of trust account used may vary depending on the design of the OPEB plan. One consideration for governments may be weighing the financial benefits of establishing a trust against the legal and human resources management implications. Many governments reserve the right to unilaterally revoke OPEB. Establishing a trust fund may be seen as conferring a permanency to the benefit plan that might not be intended.

### ■ Role of Assumptions

As they do for pension systems, economic and demographic assumptions will play a critical role in

determining the magnitude of OPEB plan liabilities (and eventually assets). Beyond the discount rate assumption discussed in the previous section, projections of health care costs and retirement rates and ages will be crucial to OPEB plans.

Health care costs have risen rapidly since the mid-1990s, with double-digit growth rates in some years. The pace of health care cost growth outstrips the salary and general inflation assumptions embedded in pension plan valuations, making OPEB liability growth potentially more volatile. Fitch expects initial variability in medical inflation assumptions, with actuaries making adjustments over time based on experience.

Retirement rate assumptions project how many plan members will leave active service and begin collecting OPEB during the valuation period. Studies have shown that the public sector work force is disproportionately made up of baby boomers, who are nearing retirement age. The pace at which they retire will have a significant effect on liability valuations and could even affect investment performance, as plan managers may have to adjust investment allocations to maintain liquidity sufficient to meet current benefit expenses. Retirement age is also important, given the existence of Medicare. In most cases, OPEB health care costs would be at least partially offset by Medicare. However, retirement age rules vary significantly among and within governments, with some plans having to carry OPEB for 10–15 years until Medicare eligibility is reached, and others facing much shorter exposure.

### ■ Implementation Issues

GASB 45 potentially creates legal, technical, and policy issues for the public sector.

**Defining the “Substantive Plan”:** Determining the precise definition of an OPEB plan is the task of the employer, in consultation with the actuary. Written documentation of the benefit plan may or may not accurately reflect the currently understood version of the plan. Employers have a financial interest in more narrowly defining the substantive plan, which may put them at odds with employee groups. Legal challenges or labor grievances can be envisioned.

**Legal Status of OPEB:** In many states and localities, pension benefits are constitutionally protected, statutorily defined, or otherwise codified. While OPEB may have the same status in some jurisdictions, many governments have greater administrative control over OPEB. If employers seek to modify or eliminate

OPEB for some workers or retirees, legal clarification may be required.

**Medicare Part D:** The implementation of the new prescription drug benefit under Medicare is under way and scheduled to go into effect Jan. 1, 2006. Integration with government OPEB plans will take time and will be complex. It is not clear at present whether this federal program will provide a financial benefit to or impose additional costs on state and local governments.

**Labor Relations:** Faced with potentially large costs to prefund OPEB plans, governments may seek concessions from active and retired employees. Conflicts could lead to work stoppages or recruitment and retention problems. Fitch expects such difficulties to appear in the more heavily unionized areas of the country.

### ■ Potential Funding Solutions

Governments will likely explore switching employees to a defined contribution system for OPEB. Once the government makes its scheduled contribution to employees or beneficiaries, all risk is transferred to the employee. While an attractive option for employers, it is likely achievable only for new hires, as existing beneficiaries have an interest in retaining the current system. Prolonged resistance by employee groups to defined contribution pension funding underscores this difficulty.

Governments facing large unfunded liabilities and steep ARCs may consider OPEB funding bonds. However, state laws are generally not explicit regarding issuing bonds for this purpose, creating a potential impediment to capital financing for OPEB. If legally allowable, OPEB funding bonds may be structured in the same manner as pension obligation bonds, which attempt to take advantage of the interest rate differential between taxable municipal bonds and the assumed investment return on plan assets. Bonds could be issued to fund all or a portion of a sponsor's unfunded OPEB liability, with the hope that the debt service on the bonds would be less than what the sponsor would otherwise have to pay in annual OPEB ARC costs over the long term.

Fitch believes that OPEB funding bonds, if used moderately and in conjunction with a prudent approach to investing the proceeds and other plan assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices could expose the plan sponsor to market losses.

Because a sponsor's unfunded OPEB liability will be factored into the rating, bond issuance would simply move the obligation from one part of the governmentwide or full accrual-based fund financial statements to another. However, Fitch notes that OPEB or pension funding bonds create a true debt, one which must be

paid on time and in full, rather than a softer liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, issuing bonds to fund an OPEB plan could have a significant effect on financial flexibility over time.

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## Other Post-Employment Benefits (OPEB)

### *New Accounting Requirements to Shed Light on Cost of State and Local Retiree Health Benefits; Funding Pressures Expected to Vary Widely*

#### Summary

Just as U.S. local and state governments are emerging from one of the most difficult fiscal periods in recent memory, they face a new hurdle in the form of accrued retiree health-care liabilities. The costs associated with retiree health benefits, though they have been magnified by growth in healthcare spending, are not a new phenomenon. Governments in coming years will have to improve their measurement and disclosure of OPEB costs and liabilities under statements 43 and 45 of the Government Accounting Standards Board (GASB). For many state and local governments rated by Moody's, the rules will apply to fiscal years starting after Dec. 15, 2006. A wide range of previously unmeasured liabilities will be reported as a consequence, and the expected drive to address these liabilities will add to the fiscal pressures governments already face from programs such as public education, Medicaid, and employee pension funding.

Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments on a broad scale. In fact, certain positive long-term effects seem likely to stem from the new requirements. This special comment describes the GASB statements and how they may affect the state and local government credit rating process. For municipal issuers, the credit impact of the new statements probably will depend on the following factors:

- The absolute size of unfunded actuarial accrued liability (UAAL) and UAAL size relative to key financial measures such as size of payroll, budget and tax base
- The plan for UAAL amortization as well as ongoing funding of new OPEB costs as incurred, on an accrual basis
- Actuarial assumptions, including discount and medical cost inflation rates, used to determine values of liability and pledged assets
- Retirement benefits promised to current workers and retirees as well as the ability (under contract or statute) to modify benefit offerings
- The impact of full funding on the issuer's financial flexibility and strength, based on measures such as debt or reserve levels
- The current credit assessment of the issuer and other factors affecting financial flexibility



## NEW RULES ARE INTENDED TO IMPROVE DISCLOSURE OF PUBLIC PAYROLL COSTS

Statements 43 and 45 will improve disclosure of costs that, along with salaries, pension benefits and pre-retirement health insurance, make up government employees' total compensation package. Like pensions, OPEB are a form of deferred pay, part of an exchange of salaries and benefits for employees' service. Their costs to employers accrue over the period of employment, even though the benefits are not provided until later. GASB's new standards require governments to measure and report OPEB costs as they are incurred, during the employment period. This mandate will force significant changes in government practice. Most governments, by measuring as expense only the outlays associated with current retirees' OPEB, have failed to capture the accrued cost and liabilities of promising retirement benefits to active workers. The actuarial methods used to estimate the cost of OPEB will be similar to those already applied to pensions. Biennial actuarial valuations of OPEB assets and liabilities will be required under the new accounting rules for state and local governments with 200 or more benefit plan participants; smaller plans will have to conduct valuations every three years and in some cases may be able to use an alternative method not requiring use of an actuary.

## OBLIGATIONS COVERED BY THE STANDARDS CONSIST PRIMARILY OF HEALTH INSURANCE

OPEB refers to retirement benefits besides pensions and early-retirement incentive (or termination) payments. These include various health-related benefits, as well as disability, life and long-term care insurance provided outside of defined-benefit pension plans. The largest component will be health insurance for which the employer pays some or all of retirees' premiums. The magnitude of this obligation will reflect the increases in prescription drug and other medical costs that have accounted for much of the recent growth in Medicaid, the joint state-federal health program for the poor.

GASB's new standards also require the inclusion in OPEB liability calculations of any implicit rate subsidy provided to retirees whose coverage is derived from a pool serving current employees (*see box*). It is because of this subsidy that even those state and local governments that do not explicitly pay part of their retirees' premium costs will likely have OPEB liabilities.

### IMPLICIT RATE SUBSIDIES

A government's retirees in many cases are able to purchase health insurance at the same premium rate as current employees based on the blending of premium rates that would apply to the two groups independently. The cost per participant of covering both groups together is higher than current employee coverage would be on its own, and not as high as the cost per participant in a group consisting solely of retirees. Because of this arrangement, retirees with blended-rate health benefits are said to receive implicit rate subsidies. The new standards require measurement and reporting of the rate subsidy of retirees, even in situations where the retirees are required to pay 100% of their stated premiums.

The rules apply to state and local governments and to government-sponsored enterprises, as well as government-owned hospitals, universities, and utilities. Non-profit organizations are covered by standards issued by GASB's sister organization for the private sector, the Financial Accounting Standards Board (FASB). Statement 43 applies to financial reports prepared by health insurance or other OPEB plans, and 45 applies to the governments themselves.

## STANDARDS ARE PART OF BROADER EFFORT TO IMPROVE ACCOUNTING FOR PENSIONS AND RELATED COSTS

The new accounting standards are part of a long-running effort in which GASB and FASB have mandated more disclosure of pension and other retirement benefit costs. FASB's Statement No. 81, issued in 1984, outlined disclosure practices for post-retirement health care and life-insurance benefits; Statement No. 87, in 1985, did the same for pension costs. Further clarification of OPEB cost reporting procedure followed when FASB issued Statement No. 106, in 1990. The same year, GASB published Statement No. 12, providing for disclosure of OPEB-related data in notes to governments' financial statements. These disclosures generally were to include the covered year's OPEB expense; the groups receiving (and the eligibility requirements for) the benefits; the respective contribution requirements for beneficiaries and employers; the statutory, contractual or other basis for the benefits, and a description of funding policy (either pay-as-you-go or paying in advance of future costs). Statement No. 12, which was intended as an interim measure, did not require the calculation of an actuarial accrued liability (AAL) or the recognition of current employees' accrued benefits. GASB in 1994 issued Statement No. 25 and Statement No. 27 to clarify how governments should report pension costs. Also at that time, it released Statement No. 26, providing interim guidance on financial reporting practices for post-employment healthcare plans administered by defined-benefit pension plans.

## INCREASED BENEFIT PRE-FUNDING, OPEB-BOND ISSUANCE AMONG LIKELY GOVERNMENT RESPONSES

Under the new rules, a government will determine the annual required contribution (ARC) needed to amortize its actuarial liability (in no more than 30 years) and to cover the "normal cost" associated with services rendered by employees during the current year. The UAAL will appear in the notes to financial statements and in a required multi-year schedule of funding progress. But to the extent that a government in a given year fails to make the full ARC, that year's funding deficit will create (or add to) a liability called the net OPEB obligation, which will appear in the statement of net assets. The rules require calculation of an annual OPEB cost that differs from the ARC once this net obligation is recorded. This cost, which must be recognized as an expense in accrual-basis financial statements, will be derived from the ARC plus interest on the net OPEB obligation.

Because failure to pre-fund benefits will result in new balance-sheet liabilities, governments may begin to set aside assets for future OPEB obligations to an increasing extent. Moreover, the rules allow a higher assumed discount rate (and hence a lower present-value actuarial liability) for plans with assets set aside in a trust for OPEB obligations than for those with no (or insufficient) assets set aside. Governments may seek to address large, unfunded liabilities for retiree healthcare through the issuance of taxable bonds similar to pension-obligation bonds. An early example of this practice is the city of Gainesville, Florida, which has issued bonds to address a \$30.6 million liability in its self-insured Retiree Health Care Plan. The credit impact of borrowing to address a retiree health plan funding deficit will depend, as it does with pension-obligation bonds, on the extent to which the debt is part of a realistic plan to address these liabilities, and on its effect on the issuer's overall debt burden.

## GOVERNMENTS HAVE BEGUN TO ADDRESS OPEB COST GROWTH

Some state governments, partly in response to the new standards, have already taken steps to reduce growth rates of their OPEB costs. Moody's expects this trend will continue, in part because improved OPEB information will encourage restraint in legislative debates and contract talks where benefits are determined. Alabama (rated Aa3 on watch for a possible upgrade) has enacted legislation increasing the premium payment obligation for various types of employees, including smokers and those who retire after a relatively short period of service. Ohio (Aa1) has modified its retiree health plan so that full coverage is available only to the employees with at least 30 years of service (*see box*).

### OHIO'S APPROACH TO POST-EMPLOYMENT BENEFITS

Ohio is one of the few states that already have accumulated assets pledged to retiree health obligations. The Ohio Public Employees Retirement System (OPERS) oversees an \$11 billion healthcare fund. Even so, because of rapid growth in both medical costs and the number of covered retirees, the OPERS trustees determined in 2003 that the health benefits fund would be used up in less than a dozen years. In September 2004, the trustees acted to restrain the fund's cost growth. They cut the portion of insurance premium coverage available to retirees with only 10 years of service to 50% for workers hired in 2002 or earlier, and to 25% for those hired later. For workers who retire with 30 years of service, however, 100% coverage was retained. The trustees also reduced retiree spouse coverage and mandated increased contributions from active workers and employers. These actions are expected to extend the longevity of the health benefits fund to 18 years. Annual benefits and program adjustments will be reviewed periodically to maintain a balance between responsibilities of the system and its members.

Utah (Aaa) passed legislation this session to change its practice of providing retirees a month of health insurance for every day of unused sick leave. This policy, which was initiated when health insurance costs were substantially lower, will be modified so that the wages for each day of unused sick leave are placed in retiree health savings accounts, which retirees will then be able to use to purchase their own health coverage. The state still will have to address the liability accumulated through its existing policy, which remains in effect through the end of calendar year 2005. Other states that have taken steps to prepare for compliance with the new OPEB accounting rules include Delaware (rated Aaa), which in May of this year formed a committee to oversee an actuarial assessment of retiree health liabilities. In 2003, Delaware performed an actuarial analysis of its retiree health benefits using a preliminary version of the GASB standard. Georgia (rated Aaa), also in May, enacted a law creating the Georgia Retiree Health Benefit Fund to receive annual contributions based on the state's ARC.

Local governments also have begun to scale back retirement health-benefit offerings for new employees. After performing actuarial assessments of liabilities, Orlando, Florida (Aa2), and Arlington, Texas (Aa2), modified the percentages of employees' healthcare premiums that are covered, as well as length-of-service requirements for eligibility.

## **RETIREMENT HEALTH BENEFITS VARY WIDELY AMONG STATES AND LOCAL GOVERNMENTS**

Retiree health benefits offered to public employees vary dramatically among state and local jurisdictions. States such as Iowa (Aa1) and Mississippi (Aa3) offer little or no health-care coverage to retired workers. Some, such as Wisconsin (Aa3) and Montana (Aa3), offer post-employment health insurance but require retirees to pay most of the cost. Still other states, such as California (A3), fully cover many retirees' health-insurance premiums as well as the majority of the premium costs for retirees' dependents. New Jersey covers retiree health insurance costs of local school teachers and college and university professors in addition to those of its regular employees. As a result, its OPEB expenditures for existing retirees already account for more than 3% of its general fund budget. A Kaiser Family Foundation survey of state governments found that in 2002, monthly premiums ranged from as little as \$105 per month for the Indiana (Aa1) Medicare complement plan to as much as \$668 per month in an indemnity-style plan provided by Alaska (Aa2).<sup>1</sup>

State and local governments are further distinguished by benefit eligibility requirements, the legal measures that provide for the benefits, and the demographic characteristics of covered employee and retiree groups. As a result, there is likely to be great variation in the relative sizes of OPEB liabilities reported.

## **OPEB FUNDING STATUS WILL BECOME A MORE VISIBLE FACTOR IN CREDIT RATING PROCESS, SIMILAR TO PENSION OBLIGATIONS**

As governments and their retirement benefit plans begin issuing financial reports in compliance with the new rules, OPEB funding status will become more visible among the many attributes Moody's assesses in the municipal credit rating process. While it will most closely resemble pension funding status, there are differences between the two types of obligations. OPEB obligations reflect medical cost trends, while those for pensions are based on salaries, over which a government's management has more control. On the other hand, retiree health benefits may be somewhat easier to modify than pensions, which may have stronger legal or contractual protection. Moody's views both OPEB and pension obligations as less binding than bonded debt, because they tend to allow some flexibility to alter the terms of the benefits (such as eligibility requirements), the assumptions used to derive the actuarial values of plan assets and liabilities, the liability amortization schedule, or other variables.

Moody's therefore will exclude OPEB liabilities from calculations of state or local debt burdens, but include them as a factor in the overall credit assessment of an issuer. This practice is consistent with Moody's approach to municipal pension liabilities. Some governments provide post-retirement health benefits through pooled programs known as cost-sharing, multiple-employer plans. For these governments, the new standards will require reporting of OPEB payments in relation to the amount contractually mandated by their cost-sharing plans. Moody's may have to rely in these cases on the financial reports of the plans, rather than of the governments participating in them, for actuarial information on OPEB funding.

## **IMPORTANCE OF OPEB TO RATING PROCESS WILL DEPEND ON ISSUER'S OVERALL CREDIT STANDING**

The extent to which OPEB funded status becomes an influential or decisive credit factor will depend on an issuer's current rating and how consistent its other attributes are with that rating. State and local governments' liabilities may be large in many cases, given the lack of prefunding in the past. For some issuers, it is possible that efforts to satisfy OPEB funding requirements will exacerbate fiscal pressure. Even so, Moody's does not anticipate that the disclosures required by the new rules will cause immediate and widespread rating adjustments. It is more likely that rating levels will be affected by observations of changes in OPEB funding measurements over time. Statistics such as the UAAL-to-covered payroll will be made available under the new rules, and Moody's expects to use these in the rating process. Plans for UAAL amortization, amortization periods, use of debt, and differences between actual and required contributions will also figure into the analysis, along with actuarial assumptions about medical costs and other variables key to estimating OPEB liabilities. Issuers' flexibility under relevant statutes or contracts to modify their post-employment health benefit offerings will likely be another focal point. Moody's also will monitor financial reserve, liquidity and debt levels that will be affected as issuers begin to set aside funds for OPEB. In general, a state or local government's effectiveness and initiative in OPEB liability management probably will influence our overall assessment of the government's management strength.

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1. Hoadley, Jack: "How States are Responding to the Challenge of Financing Health Care for Retirees"; The Henry J. Kaiser Family Foundation, September 2003.

## LONGER-TERM IMPACT OF REPORTING REQUIREMENTS WILL BE LARGELY POSITIVE

Even though compliance with the new accounting rules is expected to exert financial stress and to bring to light previously unknown liabilities, Moody's expects the disclosure effects will be largely positive over the long term. As previously mentioned, the rules will require governments to disclose and record the full current cost of benefits provided to employees. Governments will have a strong incentive, though not an obligation, to set aside funds for benefit obligations as they are incurred, which is in keeping not only with accounting principles but also with prudent financial management. Any resulting fiscal strain is likely to be more than offset in most cases by the positive implications of management practice improvements under the accounting rules.

Until the release of audited reports subject to the standards, the lack of actuarially derived OPEB liability information limits Moody's ability to make a more detailed assessment of how these future costs will affect state and local government credit. Expenditures on current retirees' healthcare costs are already incorporated in the rating process. GASB's schedule for compliance with the new OPEB reporting rules is staggered, with smaller-revenue governments afforded additional time (*see Appendix I*). For states, the first financial reporting periods subject to Statement No. 45 will be those ending during calendar year 2008. A comprehensive overview of states' OPEB funding status is therefore not likely until early 2009, when published comprehensive annual financial reports covering fiscal 2008 become available. At that time, Moody's will focus on the OPEB factors listed earlier, including the UAAL size relative to key financial indicators and the plan for UAAL amortization. Before compliant financial statements become available, Moody's may request information from issuers on various aspects of health plans and other retiree benefits that factor into OPEB liabilities (*see Appendix II*).

## Appendix I

Effective Dates	
<b>GASB 45</b>	
Government Description	Effective Date
Tier 1 (annual revenues > \$100 mln)	Yrs Starting After 12/15/2006
Tier 2 (annual revenues > \$10 mln)	Yrs Starting After 12/15/2007
Tier 3 (annual revenues < \$10 mln) Yrs Starting After 12/15/2008	
<b>GASB 43</b>	
Plan Description	Effective Date
Tier 1 (annual revenues > \$100 mln)	Yrs Starting After 12/15/2005
Tier 2 (annual revenues > \$10 mln)	Yrs Starting After 12/15/2006
Tier 3 (annual revenues < \$10 mln) Yrs Starting After 12/15/2007	
*Tiers are based on first fiscal year ending after June 15, 1999, the same basis as applied to Statement No. 34	

## Appendix II

<p>Following are examples of questions Moody's will pose pending disclosure under the new rules:</p> <p>1) Has an actuarial assessment of OPEB liabilities been performed? If so, what were the accrued actuarial liability, actuarial value of plan assets, and funded ratio?</p> <p>2) What health care and other post-employment benefits, subject to the standards, are provided? What are the benefits eligibility requirements?</p> <p>3) Describe the mechanisms (e.g., single employer or agent multiple employer defined benefit plans) through which benefits are provided.</p> <p>4) What legislative or other actions would be required to reduce the benefits cost?</p> <p>5) What is the total cost of retiree health and related benefits in the budget? How much has this sum changed in recent years, and what has accounted for that?</p>
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## Related Research

### Special Comments:

GASB 34: What Does It Mean for the Rating Process?, December 2002 (#76862)

Moody's Perspective On Increased Pension Costs For California Local Governments, June 2003 (#78417)

### Rating Methodology:

Moody's State Rating Methodology, November 2004 (#89335)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*